



Tax Alert



July 2018

Good news when entering into debt subordination agreements

When a new rule was introduced in the Income Tax Act in 2017 to deal with the income tax implications of debt reductions, an unanticipated consequence was that it could be triggered when a company entered into a debt subordination agreement, for example with a shareholder who had given a loan to the company. This could then result in taxable income in the company, because it was seen as having received a “debt benefit”.

The reason for this anomaly was that the rule provided that *any change in the terms or condition of a debt* would be regarded as a “concession or compromise”. So if your initial loan agreement provided for annual, monthly or quarterly repayments of the loan, and a debt subordination agreement was subsequently entered into which said that payments only needed to be made once the company was in a position to do so, that would be a change to the terms of the loan. Thus the debt subordination agreement would fall into the definition of a “concession or compromise”.

Once you had a “concession or compromise”, the next step would be to assess whether there was now a “debt benefit” – which again, because of the wording of the section, you were likely to have, because the market value of the loan could be argued to be less than its face value.

On 16 July 2018 the draft Taxation Laws Amendment Bill was released for public comment. The good news is that National Treasury has recognised that the rule was – to use their own words – “a blunt instrument aimed at targeting a narrow group of taxpayers”. The definition of a “concession or compromise” has now been completely replaced, and any reference to a change in the terms or conditions of a loan has been removed. The further good news is that this change will be retrospectively effective from the same date as when the rule initially became effective, being 1 January 2018, and will apply in respect of tax years commencing on or after that date. Thus, any risk attendant on having entered into a debt subordination agreement in 2018, has been removed.

The Explanatory Memorandum, which is issued when draft legislation is released, states –

“Although there is an understanding that voluntary intra-group debt subordinations may be used for tax structuring, however, the inclusion of any changes in the terms or conditions of a debt as a “concession or compromise” may have the unintended consequence of affecting legitimate transactions. This is due to the fact that in instances when debt

funding is raised with third parties such as banks; it is often required by the lender (bank) that related party debt should be subordinated.”

“A new and more comprehensive definition of a “concession or compromise” is proposed. Under this revised definition, circumstances under which the debt relief rules will apply will be limited to realisation events. *In terms of the new definition, there will be no regard to changes in the terms and conditions of taxpayers’ debt arrangements unless they result in a realisation event.*” (own emphasis)

Thus, merely entering into a debt subordination agreement would not have any tax consequences for the borrower.

The not-so-good news, unfortunately, is that there are still terms used in the new definition of “concession or compromise” that are very wide and open to different interpretations. We will be making submissions to National Treasury asking that these be clarified or amended. However, what is clear, is that the following situations will result in a “concession or compromise”, as defined –

- If a debt is cancelled or waived, or
- if a debt is interest-bearing and is converted to or exchanged for shares in the borrowing company, or the company uses the proceeds of a share issue to settle the debt, and the person who as a result acquired shares in the company, is now a connected person to the company.

In these cases, the income tax implications would need to be carefully considered.

For more information, contact:



Tanya Engels
Partner
T: +27 82 719 4018
E: tanya.engels@kpmg.co.za



Elizabeth Lombaard
Associate Director
T: +27 82 719 1988
E: elizabeth.lombaard@kpmg.co.za

[Privacy](#) | [Legal](#)

kpmg.co.za

© 2018 KPMG Services Proprietary Limited, a South African company and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ('KPMG International'), a Swiss entity. All rights reserved.

